UNITED STATES v. DAVIS: A JUDICIAL PANACEA FOR DIVIDEND EQUIVALENCY IN THE CLOSELY-HELD CORPORATION

Since the pioneering of the dividend equivalency test with respect to corporate stock redemptions, tax attorneys representing closely-held corporations have found it exceedingly difficult and at times financially disastrous to predict the outcome of a specific federal court's interpretation and application of the dividend equivalency provision. Instead, lawyers' have been forced to wander in the wilderness, and this has highly curtailed their advisory role for taxpayer-clients. This uncertainty and confusion has manifested itself in a vast log of case law, so diverse in its holdings as to paralyze the attorney in matters of corporate stock redemptions. Recently, the Supreme Court in *United States v. Davis*[1] significantly dealt with the absolute confusion in this area and fashioned a panacea for the courts which will likely remove much of the tax attorney's paralysis also. There is little doubt that *Davis* will prove to be one of the most crucial federal tax decisions in many years, and to the tax attorney for a closely held corporation, it may prove to be a bible.

This note will focus upon this judicial panacea from the standpoint of a closely-held corporation. In detail, it will examine the full scope of dividend equivalency in the pre-*Davis* era, analyze the *Davis* decision, and evaluate the effect that *Davis* will have upon the future of dividend equivalency. Finally, the note will suggest some of the problems that still remain in this troublesome area.

I

SECTION 302(b)(1) IN THE PRE-*DAVIS* ERA

A. The Vast Confusion in the Area

The search for the meaning of the phrase "essentially equivalent to a dividend" with reference to corporate stock redemptions[2] has posed one of the most troublesome tasks in the history of federal tax law. The elusive answer to this problem has caused federal courts across the country great bewilderment. The Tax Court has called the problem "exasperating;"[3] the Court of Appeals for the First Circuit has called the problem "vexing";[4] the Court of Appeals for the Fifth Circuit has echoed the problem as "nightmarish";[5] and the Court of Appeals for the Fourth Circuit has referred to it as "the morass created by the decisions."[6] Yet the courts

[1] United States v. Davis, 397 U.S. 301 (1970).

[2] INT. REV. CODE of 1954, § 302(b)(1).

[3] Thomas G. Lewis, 35 T.C. 71, 76 (1960).

[4] Bradbury v. Comm'r, 298 F.2d 111, 114 (1st Cir. 1962).

[5] United States v. Fewell, 255 F.2d 496, 499 (5th Cir. 1958).

[6] Ballenger v. United States, 301 F.2d 192, 196 (4th Cir. 1962).

have been constrained time and time again to apply this nebulous test and determine whether a corporate redemption of stock will be treated as capital gain to the taxpayer or ordinary income.

The statutory scheme for the taxation of stock redemptions is contained in Section 302 of the INT. REV. CODE of 1954. Briefly, Section 302(a) provides that the redemption shall be treated as a distribution in "payment in exchange for the stock" if any of the four paragraphs of Section 302(b) apply.[7] If a stock redemption can qualify under any of these paragraphs, the amount received shall be treated as a return of capital and the excess over the basis of the stock will be taxed at capital gain rates.

However, if the stock redemption cannot qualify under any of the four paragraphs, Section 302(d) provides that the redemption is to be taxed in accordance with Section 301 which prescribes the general rule for taxing distributions to shareholders. Under Section 301(c)(1) and by its reference to Section 316, distributions of corporate property to shareholders are treated as dividends, taxable as ordinary income to the extent of the corporation's accumulated earnings and profits.

Paragraphs 2, 3 and 4 of Section 302(b) lay down precise guidelines, or "safe harbors," for taxpayers seeking capital gains treatment. However, Section 302(b)(1) creates an imprecise and enigmatic standard which has prompted vast confusion in tax litigation. Much of this confusion has centered around the vexing question as to the extent the "business purpose" attending the redemption is to be considered in determining whether the redemption is "essentially equivalent to a dividend."

Seven courts of appeal have considered this issue, and at least four distinct attitudes have been postulated towards the significance to be accorded the business purpose of a redemption. Only the second circuit has accepted without qualification the position of the Commissioner of Internal Revenue, which has become known as the "strict" net effect test, that business purpose is immaterial in a determination of dividend equivalency.[8] Two other circuits, the ninth and tenth, have applied a so-called "flexible" net effect test, under which a legitimate business purpose of the redemption is considered as a factor militating against dividend equivalence.[9] The eighth and fifth circuits have had a third approach, which treats the question of dividend equivalence as entirely one of fact while at the same time holding that a bona fide business purpose does not require a

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[7] These four paragraphs apply when the redemption is: (1) "not essentially equivalent to a dividend;" (2) a substantially disproportionate redemption of voting stock; (3) in complete termination of the shareholder's interests; or (4) in connection with certain railroad reorganizations.

[8] *See* McGinty v. Comm'r, 325 F.2d 820 (2nd Cir. 1963); Hasbrook v. United States, 343 F.2d 811 (2nd Cir. 1965); Levin v. Comm'r, 385 F.2d 521 (2nd Cir. 1967).

[9] Kerr v. Comm'r, 326 F.2d 225 (9th Cir. 1964); Tabery v. Comm'r, 354 F.2d 422 (9th Cir. 1965); Comm'r v. Berenbaum, 369 F.2d 337 (10th Cir. 1966).

holding for the taxpayer.[10] It has been unclear which rule applied in the first and fourth circuits where the courts have vacillated between "flexible" and "strict" net effect.[11]

The sixth circuit has reflected yet another approach. It expanded the "flexible" net effect test beyond the business purpose attending the redemption. If there was a bona fide business purpose attending the issuance of the stock, and redemption of that stock was part of the pre-conceived plan of issuance, then the redemption is not "essentially equivalent to a dividend."[12]

Another problem existing with respect to dividend equivalency has posed similar conflict among the courts. This question centers upon whether the constructive ownership provisions[13] apply in determining dividend equivalence under Section 302(b)(1). Section 1.302-2(b) of the Treasury Regulations[14] explicitly provides that constructive stock ownership under Section 318(a) is one of the factors to be considered in determining dividend equivalency. This principle has been unquestionably accepted by four circuit courts of appeal.[15] However, the first circuit has retreated from this position by declaring that the imposition of the attribution rules is "not inflexible" and that a showing of discord may overcome their application.[16] Moreover, the Tax Court has taken the liberal position that at its discretion the attribution rules need not be applied.[17]

In the midst of this confusion, *United States v. Davis*[18] emerged to resolve the conflict with respect to business purpose and the attribution rules and to shed some further light upon the test of dividend equivalency. Although many substantial problems remain, the *Davis* case is highly significant in establishing some semblance of uniformity so that a taxpayer may safely foresee the potential tax consequences before a redemption is undertaken.

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10 Heman v. Comm'r, 283 F.2d 227 (8th Cir. 1960); United States v. Fewell, 255 F.2d 496 (5th Cir. 1958).

11 The first circuit first adopted the "flexible" net effect test, but recently appeared to be working toward the second circuit's view. *Compare*, *Keefe v. Cote*, 213 F.2d 651 (1st Cir. 1954), *with Bradbury v. Comm'r*, 298 F.2d 111 (1st Cir. 1962). The fourth circuit, in contrast, initially seemed to approve the "strict" net effect test, although in dicta, but in a more recent decision apparently changed its mind. *Compare*, *Ballenger v. United States*, 301 F.2d 192 (4th Cir. 1962), *with Comm'r v. Estate of Antrim*, 395 F.2d 430 (4th Cir. 1968).

12 Davis v. United States, 408 F.2d 1139 (6th Cir. 1969).

13 INT. REV. CODE of 1954, § 318(a)(1).

14 Treas. Reg. § 1.302-2(b) (1954).

15 Levin v. Comm'r, 385 F.2d 521 (2nd Cir. 1967); Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962); Comm'r v. Berenbaum, 369 F.2d 337 (10th Cir. 1966); Davis v. United States, 408 F.2d 1139 (6th Cir. 1969).

16 Bradbury v. United States, 298 F.2d 111, 116-17n. 7 (1st Cir. 1962).

17 Perry S. Lewis, 47 T.C. 429 (1966).

18 United States v. Davis, 397 U.S. 301 (1970).

B. Legislative History

In 1920, the Supreme Court declared that pro rata stock dividends do not constitute taxable income.[19] This principle spawned a new tax avoidance technique whereby a corporation could avoid dividend tax treatment by distributing earnings to its shareholders in two transactions—a pro rata stock dividend followed by a pro rata redemption. The redemption carried with it the benefit of capital gain treatment.[20] Yet the clear result of joining these two transactions was to provide the same economic consequences as a simple dividend.

In response to this new tax avoidance device, Congress enacted Section 201(d) of the Revenue Act of 1921. It provided:

> A stock dividend shall not be subject to tax but if *after* the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend. . . .[21] (Emphasis Added)

This statute was amended in 1924 to operate whether the redemption preceded or followed the stock dividend.[22] The Revenue Act of 1926 eliminated altogether the necessity for a stock dividend, extending the rule to all stock redemptions:

> If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock . . . shall be treated as a taxable dividend.[23]

This dividend equivalence test was later adopted in Section 115(g) of the Internal Revenue Code of 1939,[24] and today survives as Section 302(b)(1) and Section 346(a)(2) of the INT. REV. CODE of 1954 dealing respectively with "stock redemptions" and "partial liquidations."[25]

The question of what constitutes dividend equivalency squarely confronted the draftsmen of the Internal Revenue Code of 1954. In an

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19 Eisner v. Macomber, 252 U.S. 189 (1920).

20 Revenue Act of 1921, ch. 136, § 206(a)(6) and (b), 42 Stat. 232-33.

21 Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 228-29.

22 Revenue Act of 1924, ch. 234, § 201(f), 43 Stat. 255.

23 Revenue Act of 1926, ch. 27, § 201(g), 44 Stat. 11.

24 Int. Rev. Code o f1939, ch. 289, § 115(g), 52 Stat. 497.

25 INT. REV. CODE of 1954, §§ 302(b)(1) and 346(a)(2). The tax status of § 302(b)(1) stock redemptions are determined at the shareholder level, while the tax consequences of a § 346(a)(2) partial liquidation is determined at the corporate level. Nevertheless, both technically involve corporate distributions in redemption of stock. This note will concentrate upon dividend equivalency with respect to § 302(b)(1) with occasional references to dividend equivalency in the context of § 346(a)(2).

effort to eliminate "the considerable confusion which exists in this area" and thereby to facilitate tax planning,[26] the authors of the new Code sought to provide objective tests to govern the tax consequences of stock redemptions. As a result, the House of Representatives intentionally passed Section 302 of the tax bill without "essentially equivalent" language. Rather it provided "safe harbors" whereby a taxpayer could safely determine whether he would receive capital gains treatment.[27]

It was the Senate Finance Committee which restored the language of dividend equivalency by adding what is now Section 302(b)(1) to the Code. The Committee explained its actions as follows:

> While the House bill sets forth definite conditions under which stock may be redeemed at capital gain rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place. Accordingly, your committee follows existing law by re-inserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend.[28]

Thus, Section 302(b)(1) was codified, erecting a labyrinth in which the judiciary would time and again find itself.

At the same time that Section 302 was being structured, the draftsmen of the Code were facing another problem. Tax avoidance had been perfected among small family-owned corporations prior to 1954 through a clever manipulation of corporate funds in and out of the hands of family members.[29] To deal with this problem, Congress enacted Section 318 (a)(1)(A) which provides that:

> For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable . . . [a]n individual shall be considered as owning the stock owned . . . by . . . his spouse . . . and . . . his children, grandchildren, and parents.[30]

These so-called "attribution rules" of constructive ownership were expressly made applicable to corporate stock redemptions by Section 302 (c)(1) "in determining the ownership of stock for purposes of this section."[31] Since Section 302(b)(1) speaks in terms of dividend equiva-

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[26] H.R. No. 1337, 83d Cong., 2d Sess., 35 (1954); U.S. CODE CONG. & AD. NEWS 1954, 4025.

[27] These "safe harbors" were the conditions now found in 302(b)(2) and (3) of the 1954 Code.

[28] S. REP. NO. 1622, 83d Cong., 2d Sess., 44-45 (1954); U.S. CODE CONG. & AD. NEWS 1954, 4675.

[29] *See* the legislative history behind enactment of the attribution rules in 1954; H.R. No. 1337, 83d Cong., 2d Sess. (1954); U.S. CODE CONG. & AD. NEWS 1954 at 4061.

[30] INT. REV. CODE of 1954, § 318(a)(1)(A); The atribution rules were also developed to deal with constructive stock ownership among partners to a partnership, beneficiaries to an estate, trustees to a trust, and 50% controllers to a corporation.

[31] INT. REV. CODE of 1954, § 302(c)(1).

lency rather than stock ownership, the question has persisted whether the attribution rules are applicable in matters of dividend equivalency.

C. Net Effect or Dividend Equivalency

The most frequently enunciated test applied by the courts in an effort to identify dividend distributions is the so-called "net effect" test which had its birth in *Flanagan v. Helvering*.[32] There the court said: "But the net effect of the distribution rather than the motives and plans of the taxpayer or his corporation, is the fundamental question in administering Section 115(g) (Section 302(b)(1) of the 1954 Code)."[33] However the term "net effect" adds neither complete clarity nor certainty to this troublesome area, for it is merely a paraphrase for "essentially equivalent."[34] Thus the courts have been forced to unravel this tangling web of uncertainty through a factual case by case approach. Some of the factors which the courts have contemplated in applying the "net effect" test include:

(1) Was a bona fide business purpose present?
(2) Did the shareholder or the corporation initiate the redemption?
(3) How much earnings and profits were available in the corporate surplus?
(4) What was the past dividend record of the corporation?
(5) Did the redemption cause a substantial change in ownership or control?
(6) Was there a dislocation of relative shareholder interests?
(7) Was there a contraction of corporate operations?
(8) Was there a continuation of profitable operatons?
(9) Were the proceeds from the redemption in the same amount had the money been distributed as a dividend, hypothetically?
(10) How much time lapsed between the issuance and the redemption of the stock? and
(11) What special circumstances existed, if any, at the time of distribution?[35]

In the end, the courts must weigh all the facts and circumstances to determine dividend equivalency. However it appears that certain factors have received greater emphasis than others. As a direct result, two divergent theories of the "net effect" approach have been applied. These are most often referred to as the strict "net effect" test and the flexible "net effect" test.

1) Strict "Net Effect"

This approach places its emphasis upon a hypothetical dividend analysis. Confronted with a section 302(b)(1) problem, the courts hypoth-

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32 116 F.2d 937 (D.C. Cir. 1940).

33 *Id.* at 939-40.

34 Comm'r v. Sullivan, 210 F.2d 607, 609 (5th Cir. 1954).

35 1 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 9.100, at 268-69 (Rev. Ed. 1969).

esize a situation where the specific corporation under judicial scrutiny does not redeem any stock, but instead declares a dividend for an amount equal to that which has changed hands through the alleged redemption. Then it must examine the situation after the hypothetical dividend has been hypothetically distributed and compare it with the actual facts of the case when the stock was redeemed. If the results from the hypothetical dividend and the actual stock redemption are essentially the same, the redemption is "essentially equivalent to a dividend."

The approach in its purest form expressly rejects the business purpose of the redemption as a meaningful criterion in determining dividend equivalency. However, even the strict "net effect" test recognizes that the redemption cannot be viewed in a complete vacuum. ". . . [I]n evaluating the effect of the redemption on the future relationship between the parties, it also seems appropriate to consider whether the redemption is part of a broader plan."[36]

In *Hasbrook v. United States*,[37] the taxpayer, owner of 98% of the voting stock in WCAX Radio, Inc. (Radio) and 59.8% of the voting stock and 27% of the perferred, non-voting stock in Mt. Mansfield Television, Inc., (Television) received a cash distribution from Radio in payment for all of the taxpayer's shares in Television. The court stated that the primary considerations in a hypothetical dividend analysis were: (1) whether the alleged redemption resulted in a pro rata distribution and (2) whether the alleged redemption generated any change in basic shareholder relationships of ownership or control. Operating under these considerations, the court held that the distribution was "essentially equivalent to a dividend" inasmuch as the distribution had been pro rata to the sole owner of Radio stock, and the taxpayer continued after the distribution to hold exactly the same proportion of the common stock of Radio and Television which he had held before the distribution. Moreover, the taxpayer hadn't actually parted with any of his preferred shares in Television since after the transaction was completed he still held, for all practical purposes, the same shares through his ownership of the stock in Radio.

Similarly, in *Levin v. Commissioner*,[38] the taxpayer, owner of 484 shares[39] of a family-owned corporation through which she also received a $7,800 yearly salary, had all her shares redeemed so that her son could gain control of the corporation.[40] After the redemption the taxpayer remained as a token director, receiving a reduced salary of $1200 per year

[36] 28 J. of Taxation 346 (1968).

[37] Hasbrook v. United States, 343 F.2d 811 (2nd Cir. 1965).

[38] 385 F.2d 521 (2nd Cir. 1967).

[39] The remaining shares of voting stock in the corporation were held as follows:
Joseph Levin, brother of the taxpayer—485 shares
Jerome Levin, son of taxpayer—331 shares

[40] The corporation redeemed all of the shares owned both by the taxpayer and her brother Joseph.

and $7000 annually as distributions in redemption of the stock. In analyzing the taxpayer's position before and after the redemption, the court concluded that the redemption was "essentially equivalent to a dividend." Pursuant to an application of the attribution rules, it was clear that the taxpayer had not actually parted with any corporate ownership or control inasmuch as the redemption actually generated an increase rather than decrease in both stock ownership and annual cash payments.[41]

2) Flexible "Net Effect"

This test embraces in full the methodology of a hypothetical dividend analysis, but distinguishes itself from the stricter version by giving some, although not controlling, weight to business purpose. Where the effect of a redemption is largely that of a pro rata distribution, generating no changes in basic shareholder relationships of ownerships and control, the flexible "net effect" test may nevertheless provide capital gains treatment if there is a legitimate and compelling business purpose for the redemption.

The problem as to what constitutes a legitimate and compelling business purpose has led to varying interpretations and active disagreement among federal courts subscribing to the flexible "net effect" approach. However, it is clear that the federal courts have been willing to accept a compelling business purpose at both the shareholder and corporate levels.

In *United States v. Carey*,[42] the elimination of the shareholder was a sufficient business purpose at the shareholder level to sustain a pro rata redemption from the two 50% shareholders. After the redemption the retiring shareholder sold his remaining stock to a person who would actively manage the business, but who could not have afforded the retiring shareholder's interest had the price not been materially reduced by the redemption. The court's conclusion that the redemption was not "essentially equivalent to a dividend" was motivated by the absence of a tax avoidance scheme as well as by the presence of a business purpose that produced a major shift in ownership.

Likewise in *Perry S. Lewis*,[43] the owner of an automobile dealer franchise had all his shares redeemed, leaving corporate control solely in the hands of his two sons, after the automobile manufacturer applied heavy pressure to elder dealers like the taxpayer to yield their franchises to younger men. The Tax Court rejected an application of the attribution

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Before the Redemption	*After the Redemption*
62%—voting stock ownership (combined stock of taxpayer and Jerome)	100%—voting stock ownership (stock of Jerome)
$7800—total cash payments	$8200—total cash payments

[42] 289 F.2d 531 (8th Cir. 1961).

[43] 47 T.C. 129 (1966).

rules which would have made the taxpayer constructive owner of 100% of the shares of stock in the franchise and concluded that the business purpose for the redemption was sufficient to sustain capital gains treatment.

At the corporate level, in *Jones v. Griffin*,[44] the redemption of preferred stock to improve the corporation's credit position was a sufficient business purpose to avoid dividend equivalency. There the redemption of preferred stock issued at a 6% annual interest rate alleviated a yearly mounting debt to shareholders that threatened the existence of the corporation. Removal of this impediment permitted the corporation to obtain a bank loan at the rate of 2½% annual interest which in turn would effectuate a substantial saving and the prospects of greater flexibility in its fiscal operations.

In *Bradbury v. Commissioner*,[45] the corporation, faced with the alternative of modernizing its saw mill operations or perhaps being forced out of competition, desperately needed a bank loan to finance construction of the new mill. A bank promised to furnish the loan only if a major shareholder first discharged indebtedness owed to the corporation. To accomplish this, the corporation chose to redeem a number of his shares in cancellation of his indebtedness. In admitting that a compelling and legitimate business purpose for the redemption existed, the court nevertheless concluded that without more the redemption was "essentially equivalent to a dividend." More recently in *United States v. Davis*,[46] at the appellate level, a similar attempt to procure a government loan amounted to a substantial business purpose which by itself rewarded the taxpayer with capital gains treatment.

II

SECTION 302(b)(1) AS INTERPRETED IN UNITED STATES v. DAVIS

In prospective, *United States v. Davis* grapples with all the same dividend equivalency problems that had endlessly beset the courts in the pre-*Davis* era. Are the attribution rules applicable to Section 302(b)(1)? Is a bona fide business purpose a meaningful criterion in a determination of dividend equivalency? If not, what criteria are relevant? *Davis* took a positive stand on the first two questions and hinted at a possible answer to the third question. As a result *Davis* presents compelling law for the future of Section 302(b)(1) stock redemptions.

The facts of *Davis* mirror many of the stock redemption cases, par-

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44 216 F.2d 885 (10th Cir. 1954).

45 298 F.2d 111 (1st Cir. 1962).

46 408 F.2d 1139 (6th Cir. 1969).

ticularly that of *Commissioner v. Berenbaum*.[47] In 1945, the taxpayer Maclin Davis and E. B. Bradley organized the Tennessee Foundry and Machine Company for the purpose of manufacturing steel castings. In exchange for section 351[48] property transferred to the infant corporation, Bradley received 500 shares of common stock, and the taxpayer and his wife similarly each received 250 shares. Having a need for an additional $25,000 of working capital so that the corporation could thereby qualify for a $95,000 loan previously negotiated through the Reconstruction Finance Corporation (RFC), the taxpayer and Bradley were constrained to either make a loan evidenced by a subordinated deferred note or to purchase additional stock.

Bradley was unable or unwilling to invest additional capital but insisted upon retaining 50% of the voting power. As a result, the only methods of raising the additional capital considered by the taxpayer were the purchase by him of preferred, non-voting stock or the taking of subordinated debentures in exchange for the loan. Taxpayer chose the former from a balance sheet standpoint, and thereafter 1000 shares of Tennessee Foundry preferred stock at a par value of $25 per share were duly authorized and issued wholly to the taxpayer. At that time it was agreed among shareholders that the corporation would redeem all 1000 shares of the preferred stock as soon as the RFC loan had been fully repaid. Thus shortly, after incorporation, the outstanding shares were held as follows:

SHAREHOLDER	COMMON	PREFERRED
E. B. Bradley	500	
Maclin P. Davis	250	1,000
Edith U. Davis	250	

In 1952, the taxpayer purchased Bradley's 500 shares of common stock in the corporation and distributed them equally between his son M. P. Davis, Jr. and his daughter Edith D. Whiteman. Consequently, the then current capitalization of the corporation was distributed as follows:

SHAREHOLDER	COMMON	PREFERRED
Maclin P. Davis	250	1,000
Edith U. Davis	250	
M. P. Davis, Jr.	250	
Edith D. Whiteman	250	

On September 23, 1962, after final payment on the RFC loan had been made, Tennessee Foundry's board of directors resolved to redeem the taxpayer's preferred shares in accordance with the original understanding. As a result, on October 1, 1963, the taxpayer surrendered the certificate representing 1000 preferred shares of Tennessee Foundry capital stock and was paid $25,000.

47 369 F.2d 337 (10th Cir. 1966).

48 INT. REV. CODE of 1954, § 351.

When the taxpayer failed to report the $25,000 received by him as income, the Commissioner assessed a deficiency. Upon payment of the deficiency, Maclin Davis initiated a suit for a refund in the United States District Court of Tennessee.

A. *Davis* in the District Court and Circuit Court of Appeals

There was little disharmony in the opinions of the United States District Court of Tennessee[49] and the Court of Appeals for the Sixth Circuit,[50] as the taxpayer incontestably won the first and second rounds of a three-round bout with the Commissioner of Internal Revenue. Conceptually, both courts reasoned that the primary purpose of the net effect test was to prevent a tax avoidance scheme, and that where there was a legitimate business purpose for the corporate stock redemption, the attribution rules should not be applied mechanically to transform that legitimate purpose into the design of tax avoidance.

However, the thrust of *Davis* in the lower courts covertly harbored an expansive extension of the "business purpose" test. Analysis of the facts quickly reveals the absence of any business purpose for the redemption itself. Instead, a business purpose, if any exists, appears to be engrained in the need for an RFC loan and, as a result, materializes in the wake of the stock issuance rather than the stock redemption. It would appear to be inscruitable that the redemption had no better purpose than to vivify the terms of the original understanding.

Even though the federal courts had in the past reserved application of "flexible" net effect to only those taxpayers with a legitimate business purpose for the stock redemption, the U.S. District Court of Tennessee and the Court of Appeals for the Sixth Circuit exhibited a touch of judicial chicanery by extending business purpose to the stage of stock issuance. This maneuver was quietly executed by a simple declaration that the stock redemption was inextricably bound up in a pre-conceived plan to obtain working capital for the infant corporation, and that as a result the redemption was affected with a legitimate business purpose.

However, this argument was highly tenuous and myopic when squarely faced with the mandate of Section 302(b)(1). Initially it must be recognized from the statutory language that the only facts to be taken into account are those surrounding the stock redemption. Thus an inquiry into the design of stock issuance, even though such design contemplates a future redemption, would not be germane to the statutorily circumscribed test.

Moreover, the "business" reason for the loans appears to be nothing more than a minimum investment of risk capital. The fact is that the

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[49] Davis v. United States, 274 F. Supp. 466 (M.D. Tenn. 1967).

[50] Davis v. United States, 408 F.2d 1139 (6th Cir. 1969).

funds advanced in exchange for both common and preferred stock were advanced for the same "business" reason as is the equity of any corporation —to provide necessary capital.

> If the mere fact that a given investment was made reluctantly and only because the investment was necessary to get the business started is enough to avoid dividend equivalence upon the redemption of the stock associated with that investment, virtually all redemptions by closely-held corporations would qualify for the treatment claimed here, and the statutory rules governing distributions to shareholders of such corporations would, as a practical matter, be suspended.[51]

The taxpayer, Maclin Davis, had already withstood two, somewhat shaky, rounds with the Commissioner of Internal Revenue, and it appeared that he was home free after waging battle in the sixth circuit. However, on October 13, 1969, the United States Supreme Court granted certiorari, and one round remained to be fought.

B. *Davis* in the Supreme Court

The third round was a technical knockout for the Commissioner as the Supreme Court truncated arguments with respect to the applicability of the attribution rules and business purpose to Section 302(b)(1). In doing so, the focus was upon the legislative history of the respective provisions and what the Court regarded as their common-sense interpretations.

Against the weight of authority, the taxpayer had argued that the attribution rules made applicable "in determining the ownership of stock for purposes of this section"[52] are inapplicable with respect to Section 302 (b)(1) inasmuch as there is no explicit reference to stock ownership. The court abated this porous argument with one equally as weak, but in doing so was bolstered by the plain language of Section 302(c), the purpose and history of the attribution rules, and the future effectiveness of this anti-tax avoidance device.

Dismissing the absence of an explicit reference to stock ownership, the Court emphasized the plain language of the statute as compelling an application to all of Section 302. It was contended that this was in accord with the decisions of courts of appeal, a longstanding treasury regulation, and the opinion of the leading commentators. However, the insipid nature of the argument avoids the statutory language barrier in need of surmounting—whether the mandate of Section 302(c) was intended to encompass Section 302(b)(1), an area generally considered unrelated to ownership of stock.

For further statutory substantiation, the Court evaluated the purpose of the attribution rules and indicated that they were designed to provide a clear answer to a difficult tax problem.

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[51] Brief for Petitioner at 29, United States v. Davis, 397 U.S. 301 (1970).
[52] INT. REV. CODE of 1954, § 302(c).

> When that provision was added in the Senate, no purpose was evidenced to restrict the applicability of Section 318(a). Rather, the attribution rules continued to be made specifically applicable to the entire section, and we believe that Congress intended that they be taken into account whenever ownership of stock was relevant.[53]

However, again the Court instilled probative character in negative evidence to reach the conclusion that the attribution rules were intended to be non-restrictive. Furthermore, the Court's language undercuts the probative weight of their judgment. Their conclusion "that Congress intended that they be taken into account wherever ownership of stock was relevant," was not nor never has been in dispute. Rather the inquiry should have focused upon whether ownership of stock is relevant to dividend equivalency. Only in this way could the taxpayer's argument have been properly disposed.

Notwithstanding, the posture of the Court's logic was somewhat enhanced by a reliance upon the policy value posed in the future effectiveness of the attribution rules. On this level, the court reasoned:

> . . . it was necessary that the attribution rules apply to Section 302(b)(1) unless they were to be effectively eliminated from consideration with regard to Section 302(b)(2) and (3) also. For if the transaction failed to qualify under one of those sections solely because of the attribution rules, it would according to taxpayer's argument nonetheless qualify under Section 302(b)(1).[54]

Even this argument is somewhat farfetched, for it seems to overlook the difficult standards exclusive of constructive ownership that form the lifeblood of dividend equivalency. In any case, it would appear that the decision with respect to the attribution rules was fashioned solely upon the fear that non-application to Section 302(b)(1) would "nullify its explicit directive"[55] and thereby facilitate tax avoidance.

Just as unconvincingly, the Court utilizes legislative history to dissipate the business purpose argument. Without deciding whether business purpose was relevant to dividend equivalency in pre-1954 tax law, the Court commenced its probe into legislative history with the report of the Senate Finance Committee, who had added the dividend equivalency provisions to the House bill. The Senate Finance Committee had originally criticized the House bill, passed without what is now Section 302(b)(1), as ". . . unnecessarily restrictive, particularly in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption takes place."[56]

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[53] United States v. Davis, 397 U.S. 301, 306-07 (1970).

[54] *Id.* at 307.

[55] *Id.* at 307.

[56] S. Rep. No. 1622, 83d Cong., 2d Sess., 44-45 (1954); U.S. Code Cong. & Ad. News 1954, 4675.

From this brief explanation, the Court reasoned that the absence of an indication that the purpose behind the redemption should affect the result was persuasive evidence that no such construction was intended.

However, the key to *Davis* probably rests in the Court's reference to the Senate purpose behind the 1954 version of Section 302(b)(1).

> Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation.[57]

The Court ruled that this passage demonstrated a legislative rejection of past court decisions that had been motivated by the presence or absence of a tax avoidance motive. Instead the legislature intended to reject business purpose "by making the sole inquiry relevant for the future the narrow one whether the redemption could be characterized as a sale. . . ."[58]

However, again the Court is toying with linguistics. Irrespective of whether you characterize a redemption as a sale or as a non-dividend distribution, you are nevertheless confronted with the recurring problem whether factors irrelevant to the basic criteria should be permitted to effect or even resolve a Section 302(b)(1) controversy. The legislative history fails to fill the statutory vacuum evident in this area.

The most sensible rationale would have been an open admission that the new rule was required on policy grounds to end the turmoil prevalent in this area. However, such matters are often not open to the Court when confronted with legislative history. In any case, the Court probably preferred what appeared to be a more substantial and durable legal rationale, and thus chose the overly vague language of Section 302(b)(1)'s legislative history.

> If the *Davis* decision has any redeeming feature it is the simplification of a tangled case law, both as to what constitutes a valid business purpose and as to whether a 'corporate' purpose can be distinguished from a 'stockholder' purpose in close corporations. In any event, it would seem that simplification should not require such a strained statutory interpretation.[59]

C. The Aftermath and a Portent for Dividend Equivalency

The effects of *Davis* should be felt throughout the business community as closely-held corporations will likely attempt to regroup their forces and find new means of achieving capital gains treatment.

Initially, the most obvious effect of *Davis* will be to eliminate the "flexible" net effect or business purpose test from federal tax law. This will elicit a swift and radical change in many of the circuits, inasmuch

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57 *Id.* at 234, U.S. CODE CONG. & AD. NEWS 1954 at 4870.

58 *Id.*

59 2 RABKIN & JOHNSON, FEDERAL INCOME GIFT AND ESTATE, TAXATION, 24.02 at 2416-417 (1970).

as the majority of them had accepted the "flexible" approach or some variation thereof. Consequently, "the business purpose of a transaction is irrelevant in determining dividend equivalence"[60] under Section 302(b)(1).

Yet the demise of the "flexible" net effect test has other far-reaching effects. It suggests that the Court is attempting to draw a line beyond which business considerations cannot enter into a determination of dividend equivalency. If this analysis is correct, then *Davis* strips the net effect test of all components except the so-called "hallmarks of a dividend"—substantial change in basic shareholder relationships and a non pro rata distribution. Other considerations utilitarian in the past such as contractions in corporate operations, the past dividend record of the corporation, continued profitable operations of the corporation, and other special circumstances existing at the redemption are drained of their vitality with respect to dividend equivalency. The reason for this is quite simple. Parallel to the test of business purpose, these considerations relate to the good intentions or tax avoidance motives of the taxpayer or the corporation in carrying out the redemption. However, dividend equivalency is more concerned with whether a transfer of property from a corporation to its shareholders causes a change in relative economic interests or rights of the stockholders. This question cannot be meaningfully pursued by an approach which places value upon the past dividend record of the corporation, for example, a consideration relative only to tax avoidance motives. Thus *Davis* has in all probability accomplished a major job of spring housecleaning with respect to net effect so as to eliminate all considerations except the "hallmarks of a dividend."

Furthermore, the rationale and language of *Davis* may prove to play a significant role in the future of Section 302(b)(1). Up to this time, the courts have chosen to focus upon the transfer of stock from the perspective of a dividend analysis. Of course, the "hallmarks of a dividend," emerging from this have been scrutinized to debunk the invalid claims of taxpayers. However the language of *Davis* that the inquiry of Section 302(b)(1) "will be devoted solely to the question of whether or not the transaction may properly be characterized *as a sale of stock* by the redeeming shareholder to the corporation" may cause some courts to redirect their inquiry under Section 302(b)(1) given the proper set of facts. The sale language may result in a Uniform Commercial Code argument that centers upon the question whether any phase of the redemption resulted in an actual passage or transfer of title to property, rather than the more conventional "hallmarks of a dividend" analysis. If the facts in a particular case indicate the transfer of title to property consanguineous to the redemption of stock, the redemption may not be "essentially equivalent

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60 United States v. Davis, 397 U.S. 301, 312 (1970).

to a dividend" even though it is itself pro rata and does not affect substantial shareholder relationships of ownership and control. The potential linguistical problem has already shown signs of development in the Tax Court's recent indication of some willingness to accept literally the sale language of *Davis*.[61]

In the *Estate of William F. Runnels*,[62] the Tax Court was given the first opportunity to examine and apply the new *Davis* rule. In 1963, Lou Ella Runnels and William Runnels, owners of 47.5% and 52.5% respectively of Runnels Chevrolet, Inc., contracted for construction to begin on a building located on their property. All construction costs were incurred by the corporation, but payments in turn were charged on the corporate books to Lou Ella and William as accounts receivable for a total amount of $68,122.87. In 1964, the corporation redeemed 167 and 184 shares respectively from Lou Ella and William and credited their accounts in the amount of $68,122.87, thereby extinguishing their indebtedness.

Reinforced by the *Davis* language, the taxpayer astutely argued that the transaction was a sale of the building by the corporation to Lou Ella and William in consideration of some cash and some stock. However the Tax Court wisely skirted the potential issues raised by this argument by holding that there could be no sale of the building to the taxpayers inasmuch as the building had been owned by them from the start, and the money had merely been loaned from the corporation to finance its cost. With the taxpayer's argument derogated, the court proceeded to decide the case on the established principles of a pro rata distribution. Since Lou Ella and William owned 47.58% and 52.42% of the corporate stock respectively after the redemption, the redemption was substantially pro rata and therefore capital gains treatment must be denied. Although the *Runnels* case will not be highly significant in federal tax law, it nevertheless is valuable in its emphasis upon the sale of stock inquiry as the key to *Davis* and its recognition by implication that a taxpayer's sale argument may overcome dividend equivalency where the sale has more merit than in the *Runnels* set of facts.

A third effect of *Davis* will be to effectively eliminate Section 302(b)(1) in family owned close corporations or one-man corporations. From the standpoint of family corporations, the applicability of the attribution rules will in most cases foreclose the use of Section 302(b)(1) since after their application, most redemptions will be pro rata. Of course this development is not revolutionary. Most of the courts have in the past subscribed to the applicability of the attribution rules with regard to dividend equivalency. It was only the exceptional situation where a court exercised its discretion and restraint in the matter. Yet the attribution

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61 Estate of William F. Runnels, 54 P-H Tax Ct. 541 (1970).
62 *Id.*

rules do not close the door entirely upon family corporations since their applicability is statutorily limited to the spouse plus one step in the direction of ancestors (parents) and two steps toward descendants (children and grandchildren). Thus one can avoid the attribution rules by distributing such portion of one's interest as one wants within the family structure to a son-in-law, brother, sister or nephew.[63] However, once the attribution rules are appropriate and the result is the emergence of a single shareholder, the mandate of *Davis* is quite clear:

> Where a taxpayer who is the sole stockholder, after application of the attribution rules, causes part of his shares to be redeemed by the corporation, such redemption is always "essentially equivalent to a dividend."[64]

Although loopholes still exist in the attribution rules to permit Section 302(b)(1) capital gains treatment with respect to the family owned close corporation, *Davis* ensures that such treatment will not be available to the one-man close corporations (by virtue of the attribution rules or not).

Moreover, *Davis* may prove to play a crucial role in the shaping of federal tax law with respect to corporate reorganizations. According to Section 354(a)(1) of the Internal Revenue Code of 1954, there is a nonrecognition of gain or loss "if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." However Section 356 relaxes this stern rule that the exchange must be "solely" for stock or securities. If the taxpayer receives "boot" as well as non-recognition property, his gain, if any, is to be recognized, but in an amount not in excess of the boot.

The amount of gain to be recognized having been determined under Section 356(a)(1), the provisions of Section 356(a)(2) then determine whether taxation shall be accorded capital gains or dividend treatment. Section 356(a)(2) provides that the taxpayer's gain must be recognized as a dividend to the extent of his ratable share of post-1913 earnings and profits, if the exchange has the "effect of the distribution of a dividend."

"As a result of some imprecise statements in *Commissioner v. Estate of Bedford*,[65] it was assumed for many years that Section 356(a)(2) automatically converted any recognized gain into dividend income, to the extent of the distributing corporation's earnings and profits, where the taxpayer continued as a shareholder after the exchange."[66] This "auto-

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[63] *See*, U.S.C. 9TH INSTITUTE 89 (1957).

[64] United States v. Davis, 90 S. Ct. 1041, 1042 (1970).

[65] 325 U.S. 283 (1945).

[66] BITTKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 592 (2nd Ed. 1966). However, it appears that there may be a dispute over whether the language of *Estate of Bedford* is imprecise or overly broad. For the latter position, *see* HURWITZ, BUSINESS PLANNING 401 (1966).

matic dividend" test was an unsatisfactory result, particularly from the facts of the *Bedford* case where cash was distributed in a recapitalization to discharge arrearages in preferred dividends. Thus, several of the lower courts have retreated from *Bedford's* "automatic dividend" test.[67]

In accordance with some of the leading commentators, it has been suggested that the phrase "has the effect of a distribution of a dividend" as utilized in Section 356(a)(2) should be interpreted as employing the same test as dividend equivalency under Section 302(b)(1).[68]

"Although there is no explicit statutory coordination between the stock redemption rules of Section 302 and Section 346 and the boot distribution rule of Section 356(a)(2), the principles developed in interpreting Section 302 and possibly Section 346 can be helpful in reaching a satisfactory result under Section 356(a)(2)."[69]

The *Davis* case expressly cites *Commissioner v. Estate of Bedford* as relevant law that under the essentially equivalent provision of Section 115(g)(1) of the 1939 Code, it may have been improper for the courts of appeal to rely on "a business purpose for the redemption" and "an absence of the proscribed tax avoidance purpose to bail out dividends at favorable tax rates."[70] This citation might suggest to many of the federal courts that the "essentially equivalent to a dividend" test was meant to operate in the area with which *Bedford* dealt—the boot distribution rule of Section 356(a)(2). If such a suggestion is adequately pursued, *Davis* may result in the complete erosion of *Bedford's* "automatic dividend" test and a supplantation by the *Davis* test with respect to boot distribution in corporate reorganizations.

Furthermore, *Davis* may prove to have an effect upon the accumulated earnings tax provisions of the Code, Sections 531-537. Pursuant to the statute and the 1969 amendments to it, any corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being distributed as a dividend,"[71] shall pay an accumulated earnings tax of 27½% of accumulated taxable income not in excess of $100,000, and 38½% of accumulated taxable income in excess of $100,000.[72] "The fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid

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67 *See* Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl. 1958); Hawkinson v. Comm'r, 235 F.2d 747 (2d Cir. 1956).

68 BITTKER AND EUSTICE, *supra* note 66.

69 *Id.*; also *see* Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 TAX L. REV. 573 (1965).

70 397 U.S. 301, 310 (1970).

71 INT. REV. CODE of 1954, § 532(a).

72 INT. REV. CODE of 1954, § 531.

the income tax with respect to shareholders."[73] These provisions impose a severe financial penalty upon those corporations who fail to heed the statutory warning; and therefore, tax attorneys must be particularly sensitive to these provisions in which advisory role to closely-held corporations.

Prior to *Davis*, many closely-held corporations attempted to utilize the stock redemption device as a means of distributing surplus income to shareholders at capital gains rates. These attempts were sporadically successful, thanks largely to the "business purpose" test. However, *Davis* effectively defeated this tax avoidance device. As a result, it is likely that, after *Davis*, closely-held corporations will both constrict the number of redemptions as well as the payment of dividends so as to avoid the harshness of dividend tax treatment. If this course is followed, many closely-held corporations will unknowingly find themselves paying a double penalty—the 27½% and 38½% accumulated earnings tax paid at the corporate level as well as the dividend tax paid at the shareholder level upon the ultimate distribution of the earned surplus as dividends.

It is crucial that closely-held corporations and their tax consultants be aware of this pitfall so that in avoiding the Scylla of *Davis*, they do not cast themselves into the Charybdis of the accumulated earnings tax. This avoidance may best be accomplished by tailoring its accumulated earnings only to the "reasonable needs of business" as defined by Section 537. Interpretation of Section 537 will probably provide a focal point for future litigation in the area of the accumulated earnings tax. There can be little doubt that such future litigation is an offspring and long-range effect of the *Davis* ruling.

A final effect of the *Davis* decision will be a proliferation of corporate attempts to obtain a Section 162 deduction for the "ordinary and necessary" business expenses of a redemption with a compelling business purpose. In *Five Star Mfg. Co. v. Commissioner*,[74] a closely-held corporation, whose business and success revolved around the use of certain patents from a patent licensing agreement, found itself on the verge of bankruptcy when Smith, a 50% shareholder, drew heavily over a period of years from Five Star's treasury, causing the corporation to slide into great debt. The owner of the patents threatened to cancel the patent licensing agreement unless Smith was removed from the corporate picture as a shareholder. Confronted with a struggle for corporate survival, Five Star obtained a judicial order for the sale of Smith's stock, and at the sale Five Star became the purchaser of its own stock. When the corporation sought an "ordinary and necessary" business deduction for expense in redemption of Smith's stock, the court held:

> Corporation's payment to 50% stockholder to terminate his interest in

[73] INT. REV. CODE of 1954, § 533(a).

[74] 355 F.2d 724 (5th Cir. 1966).

> corporation was deductible as ordinary and necessary trade or business expense, where removal of stockholder would permit the corporation again to use assets for income production by freeing its management from unwarranted fetters.[75]

The thrust of *Five Star* is that a compelling business purpose for redemption of stock may be sufficient to achieve a Section 162 business deduction. Thus, blocked by the mandate of *Davis* in obtaining capital gains treatment for shareholders for the redemption of stock with a compelling business purpose, closely-held corporations will likely argue their right to a Section 162 business deduction under the *Five Star* rationale. However, it is just as likely that the Commissioner will argue that the abatement of a business purpose exception under *Davis* was intended to fashion an expansive remedy for the mass confusion and inequality of treatment among jurisdictions subscribing to a variety of business purpose tests. Allowance of a Section 162 business deduction for redemptions with a compelling business purpose would reopen Pandora's Box in derogation of the letter and spirit of *Davis*, by once again permitting the courts to fashion their own definitions and applications of a compelling business purpose. Of course, in counter-argument, closely-held corporations will contend that *Davis* must be confined to the area of dividend equivalency, and that Section 162 is guided by its own unique set of values. Irrespective of which argument is more easily digested, the conflict presents an interesting and significant ground for future tax litigation.

III

PROBLEMS THAT STILL REMAIN

A. The Attribution Rules

Although *Davis* seems to resolve the problems posed by the attribution rules with respect to dividend equivalency, this resolution may prove to be shortlived. It is irrefutable that in some cases, application of the attribution rules works great hardship and inequity. In the past, a few courts faced with this realization have construed their application to Section 302(b)(1) as discretionary.[76] *Davis* effectively puts to rest such an argument. However it may well come to pass that the *Davis* decision will signal the carrying out of a selective group of non-statutory exceptions to the attribution rules.

A few of the courts have notably suggested that family hostility or estrangement and the complexity of preferred stock situations may render the application of the family attribution rules unwise.[77] This suggestion

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[75] *Id.*

[76] Perry S. Lewis, 47 T.C. 429 (1966); Estate of Arthur Squier, 35 T.C. 950 (1961).

[77] Levin v. Comm'r, 385 F.2d 521, 526 (2d Cir. 1967); Estate of Arthur Squier, *id.*

has also manifested itself in the texts of some of the leading commentators.[78]

Of course, a family hostility exception would be predicated upon the fact that the purpose in enactment of the attribution rules—namely, to prevent tax avoidance and evasion of the complete redemption test in Section 302(b)(3), while at the same time providing definitive rules for the guidance of taxpayers[79]—would not be served where bona fide hostilities had driven the family apart. After all, there is nothing sacred about the family unit once the parties are estranged. On the other hand, it might be argued that it is not the proper role of the court to become embroiled in what appears to be a family dispute.

A preferred stock exception has been suggested because of the complexities of multi-class capitalization and the language of Section 302(b)(1)'s legislative history.

> While the House bill set forth definite conditions under which stock may be redeemed at capital gain rates, these rules appeared unnecessarily restrictive particularly in the case of redemptions of *preferred stock* which might be called by the corporation without the shareholder having any control over when the redemption may take place.[80] (Emphasis Added)

This legislative history has at times been interpreted as suggesting that preferred stock presents special problems where voting common is not also simultaneously redeemed that must be dealt with in an often unconventional fashion. Armed with these arguments, a taxpayer may very well raise the issue of these exceptions to the attribution rules. Up to the present time, the courts have refused to recognize specific non-statutory exceptions to the attribution rules.[81] The courts, however, may find it necessary to carve such exceptions in the future.

B. Multi-Class Capitalization

After the application of the attribution rules, the facts of *Davis* provided an irreducible and elementary situation for a further application of the principles of dividend equivalency. Maclin Davis had been the constructive owner of the entire common and preferred capital stock issued by the corporation, and consequently, the only rational characterization of a distribution in partial redemption of his preferred stock would be that of a dividend.

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[78] BITTKER AND EUSTICE, *supra* note 66 at 292.

[79] H.R. NO. 1337, 83d Cong., 2d Sess., , (1954); U.S. CODE CONG. & AD. NEWS 1954, 4061.

[80] *Supra* note 28.

[81] *See*, however *Estate of Arthur Squier*, 35 T.C. 950 (1961), where the court apparently disregarded an application of the attribution rules to an estate's proportional ownership of a close corporation because ". . . the record herein reveals a sharp cleavage between the executor and members of the Squier family." at 955.

Limited to its facts, *Davis* presents compelling law where a taxpayer is the owner of common stock in a single-class capital-structured corporation and where a taxpayer is the 100% owner (constructive or not) of the entire stock in a corporation having multi-class capitalization. However, where a taxpayer is not a 100% owner of the entire stock in a corporation having multi-class capitalization, the problems become manifest. It is this ocean which needs to be charted and sailed upon by the Supreme Court.

The redemption of preferred stock in a multi-class capital structure does present special problems. The Senate Finance Committee was well aware of these problems when it talked of its purpose in drafting what is now Section 302(b)(1).

> While the House bill set forth definite conditions under which stock may be redeemed, at capital gains rates, these rules appeared unnecessarily restrictive particularly in the case of redemptions of preferred stock. . . .[82]

Stock which is nonvoting, limited and preferred as to dividends and in liquidation is closely consonant to a debt security. This relationship presents interesting incongruities since debt capital, assuming no problem of thin capitalization,[83] may generally be repaid free of tax regardless of the pro rata character of the payment. Of course, this result is precluded where the capital is labeled "preferred stock" and the distribution is pro rata. The vast discrepancy in results precipitated by the labels attached and the absence of adequate guidelines for distinguishing the use of each label causes one to stop and contemplate whether the retirement of preferred stock should be governed by the same principles as repayment of debt—namely, a tax-free recovery of invested capital.[84]

At the very least, however, non-litigious taxpayers should be offered a "safe harbor"—a nonexclusive, arbitrarily defined area of debt—by reference to which, together with their lawyers, they could plan the capitalizations of closely-held corporations confident that certain payments to them would be treated as a return of capital with interest income.[85] It appears that this result may be forthcoming in the light of Section 385(a), an addition to the Internal Revenue Code by the Tariff Reform Act of 1969,[86] which delegates the power to issue guidelines in the debt-equity area.[87] Creation of this "safe harbor" by the Treasury would probably obviate the use of preferred stock as a capitalization device.

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[82] *Supra* note 28.

[83] BITTKER AND EUSTICE, *supra* note 66 at 125.

[84] *See*, SURRAY AND WARREN, FEDERAL INCOME TAXATION 1551 (1960).

[85] *See*, *Toward New Modes of Tax Decisionmaking—The Debt-Equity Imbroglio and Dislocation in Tax Lawmaking Responsibility*, 83 HARV. L. REV. 1695 (May 1970).

[86] Pub. L. No. 91-172, § 415(a), 83 Stat. 613 (1969), codified at INT. REV. CODE of 1954, § 385.

[87] For an excellent analysis of this new statute, *see supra* note 85.

Furthermore, the pro rata standard has implications not present in the case of a pro rata redemption of common stock. Whether a distribution in redemption of preferred stock is pro rata with respect to preferred stock alone is irrelevant. Rather, the focus has centered upon whether the common and preferred stock together are held in substantially the same proportions before and after the alleged redemption.[88] The complexity of this inquiry is proliferated when several classes of both voting and non-voting preferred stock are present.

Moreover, in the redemption of a pro rata portion of a shareholder's preferred stock, a shareholder's right to recover his invested principal and to receive all future preferred dividends is pro tanto reduced. These elements are not affected in a pro rata redemption of common stock. Thus, the mere fact that a distribution in redemption of preferred stock is pro rata with respect to preferred shares is not an adequate gauge of dividend equivalency. The crucial question upon which the courts should focus where common and preferred shares are held in equal proportions is whether the redemption of preferred stock is actually a distribution in retirement of preferred stock or a disguised dividend on common stock. If the redemption is the former, capital gains treatment should be accorded; while if the latter, the distribution should be taxed as a dividend.

In *Himmel v. Commissioner*,[89] a federal court had a rare opportunity to deal with the problem of dividend equivalence in a multi-class capital structure with significant result. There the taxpayer loaned money to his jointly-owned corporation which later discharged the debt by issuing two classes of preferred stock, one voting and the other non-voting. The taxpayer made a gift of his common stock to his sons, but retained control of the corporation through his voting preferred stock. When the corporation acquired some surplus cash, it redeemed all of the non-voting preferred and a part of the voting preferred. However, the taxpayer again remained in control of the corporation through constructive ownership of his sons' shares.

The court recognized that in single-class capitalization, the net effect of a redemption may be adequately gauged by a pro rata standard since all rights exist in proportion to the shares held. However, in multi-class capitalization, the pro rata standard is not enough inasmuch as additional classes will most often be preferred shares without voting rights and with limited rights to participate in earnings and liquidations (to the extent of capital contributed). Consequently, the court indicated that the redemption of some preferred shares may cause more heterogeneous changes in a shareholder's package of total rights than would a redemption of common stock.

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88 Treas. Regs. § 1.302-2(a) (1955).

89 338 F.2d 815 (2nd Cir. 1964).

In rejecting the lumping together of all different classes of stock, the court suggested that the proper test was that of the "hallmarks of a dividend"—was there a pro rata distribution of earnings and profits and was there any change in basic shareholder relationships of ownership or control. Focusing upon the latter test, it held that the distribution to the taxpayer was "essentially equivalent to a dividend."

The *Himmel* case suggests three significant theories with respect to dividend equivalency in a multi-class capital structure.

1. where voting shares are redeemed, a determination of net effect permits a grouping together of common and preferred stock, if only to gauge the impact on voting power.
2. where non-voting shares are redeemed, all classes of common and preferred shares should not be lumped together for purposes of determining reduction in ownership, since joinder is not relative to any significant aspect of the complex of shareholder rights.
3. the net worth test (changes in relative shares of net worth attributable to each shareholder) is the proper inquiry in multi-class capitalization.

The dearth of redemption cases involving the complex of a multi-class capital structure has prevented the erosion, modification or augmentation of the *Himmel* decision. Nevertheless, in the near future the Supreme Court will likely journey across this ocean and chart a new course for dividend equivalency.

IV

CONCLUSION

United States v. Davis[90] appears to be one of the most significant federal tax decisions in recent years. Its mandate may seriously affect decision-making at many levels in the closely-held corporation. Notwithstanding, it is now patent that the redemption device in conjunction with Section 302(b)(1) may not be used as a vehicle to distribute what is actually or constructively a dividend at capital gains rates even though a compelling business purpose for the redemption exists.

With the abatement of a business purpose exception, closely-held corporations and their shareholders must rely more upon the "safe harbors" of Sections 302(b)(2) and (b)(3) for capital gains treatment. Section 302(b)(3) probably provides the surest and safest harbor for capital gains treatment, inasmuch as the attribution rules are made expressly inapplicable where the redemption is in complete termination of a shareholder's interest. Thus, had Mrs. Levin in *Levin v. Commissioner*[91] not retained a token directorship and salary with her family-owned corporation, the attribution rules would have been effectively neutralized and

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90 United States v. Davis, 397 U.S. 301 (1970).

91 385 F.2d 521 (2nd Cir. 1967).

the redemption of *all* of her capital stock in the corporation would have received capital gains treatment.[92] Future taxpayers should give *Levin* more than a quick glance when planning a Section 302(b)(3) redemption.

The judicial panacea provided by *Davis* could operatively encourage the profitable closely-held corporation to go public. Although many small corporations desire to keep corporate control in the hands of a closely-knit circle, it may well be that the tax advantages in avoiding the attribution rules and the pro rata standard will operate to overcome the initial skepticism of publicly-owned status and control.

In summation, *Davis* will have a multitudinous effect upon many areas of the federal tax law. At the present, its greatest asset is the unraveling of many of the enigmatic characteristics of dividend equivalency and the assumption of a new degree of consistency in this troubled area. However, many problems will persist in this vexing field, and *Davis* will continue to play a significant role toward their solution.

Gary Douglas Greenwald

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[92] According to § 302(c)(2)(A)(i), the attribution rules are not applicable if "immediately after the distribution, the distributee has no interest in the corporation (including an interest as director or officer) except as a creditor."